

Tax Law Update

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With 2013 Oregon Income Tax Changes, Some Businesses Should Revisit Their Ownership Structure

Oregon business owners operating in the form of sole proprietorships, wholly-owned LLCs, and closely held C corporations may wish to reconsider their business structure due to upcoming changes in Oregon tax law. As a result of the so-called “Grand Bargain” enacted by the special 2013 Legislative session and signed into law on October 8, business income earned through pass-through entities such as partnerships and S corporations will potentially be taxed at lower rates starting in 2015. As a result, operating a business through a pass-through entity will become more attractive for many business owners.

Currently, taxpayers subject to the Oregon personal income tax are taxed at the following rates:

Tax Rate	Taxable Income Subject to Rate
5.0%	\$0 - \$2,000
7.0%	\$2,001 - \$5,000
9.0%	\$5,001 - \$125,000
9.9%	Above \$125,000

For tax years beginning on or after January 1, 2015, if certain conditions are met, a taxpayer’s “nonpassive income” attributable to an S corporation or partnership (including a multi-member LLC that is taxed as a partnership) will be taxed at the following rates (the “Reduced Rates”):

Tax Rate	Taxable Income Subject to Rate
7.0%	\$0 - \$250,000
7.2%	\$250,001 - \$500,000
7.6%	\$500,001 - \$1,000,000
8.0%	\$1,000,001 - \$2,500,000
9.0%	\$2,500,001 - \$5,000,000
9.9%	Above \$5 Million

“Nonpassive income” is any income other than (1) wages, (2) interest, (3) dividends, (4) capital gain, and (5) income from a “passive activity,” as determined under Section 469 of the Internal Revenue Code. The federal tax rules relating to passive activities are extremely complex, but, in general, nonpassive income will include operating income from a business in which the taxpayer works more than 500 hours during the year. Special rules apply to rental income. Business owners should consult their professional tax advisors to identify their nonpassive income.

Importantly, income derived from proprietorships and activities conducted through single-member LLCs, all of which are reported on Schedule C of the Form 1040, will not be eligible for the Reduced Rates. Business owners with Schedule C businesses should consider using an S corporation or forming a tax partnership with another owner. Simply transferring a one percent interest to a spouse or a wholly-owned S corporation may suffice to create a tax partnership, as long as the parties act consistently with the form of the transaction.

The Reduced Rates will not apply to a business owner’s nonpassive income from a pass-through entity unless non-owner employees who work 30 or more hours a week perform at least 1,200 hours of work in Oregon during the tax year. This requirement may create a peculiar incentive for spouses who jointly own and operate a business to cause one spouse to be a non-owner employee rather than a joint owner. Such a step should not be taken without advice of a tax professional.

Interestingly, the Reduced Rates are subject to potential adjustment after 2018, and again after 2022, if the Legislative Revenue Officer determines that the State’s revenue losses from the Reduced Rates are significantly different from what is projected. Since projections have not yet been done, it is difficult to predict whether adjustments are likely.

Beginning in 2015, operating a business through a pass-through entity may reduce the owner’s Oregon income tax, but careful planning will be required. Business owners should consult their professional tax advisors to determine whether restructuring their businesses will be beneficial.

**For more information, please contact the Tax Law Practice Group
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